99TH CONGRESS
1st Session

SENATE

REPORT
99-22

FIRST MONETARY POLICY REPORT FOR 1985

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

A REPORT

together with

MINORITY VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523

APRIL 2 (legislative day, FEBRUARY 18), 1985.—Ordered to be printed.

U.S. GOVERNMENT PRINTING OFFICE

45-445 O

WASHINGTON : 1985

S243-2.

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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, April 2, 1985.

Hon. GEORGE BUSH,
President of the U.S. Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the First Monetary Policy Report for 1985 on the Conduct of Monetary Policy, pursuant to Public Law 95–523 and oversight hearing held on February 20, 1985.

Sincerely yours,

JAKE GARN, *Chairman.*

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APRIL 2 (legislative day, FEBRUARY 18), 1985.—Ordered to be printed

Mr. DOLE (for Mr. GARN), from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

MINORITY VIEWS

[Submitted pursuant to Public Law 95-523]

FIRST MONETARY POLICY REPORT FOR 1985

On February 20, 1985, the Committee on Banking, Housing, and Urban Affairs received this year's first "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (Public Law 95-523) from the Board of Governors of the Federal Reserve System.

Also on February 20, 1985, Federal Reserve Board Chairman Paul A. Volcker, testified before a Banking Committee hearing on monetary policy.

MONETARY POLICY

At that hearing, Chairman Volcker announced the Federal Open Market Committee's [FOMC] target ranges for growth during 1985 in M1, M2, and M3 as well as the Committee's monitoring range for growth in the debt of domestic nonfinancial sectors. These ranges are summarized in table I.

TABLE I.—1985 MONETARY GROWTH RANGES

Aggregate	Growth range (percent)
M1	4.0 to 7.0
M2	6.0 to 9.0
M3	6.0 to 9.5
Debt	9.0 to 12.0

The Federal Reserve Chairman told the Banking committee that the latest seasonal and benchmark revisions to monetary aggregate data show that M1 and M2 grew within their target ranges for all of 1984 while M3 grew faster than its target range. Domestic nonfinancial debt also grew faster than its monitoring range. These data are summarized in table II.

TABLE II.—1984 MONETARY GROWTH RANGES AND REALIZED GROWTH

Aggregate	Growth range (percent)	Realized growth (percent)
M1	4.0 to 8.0	5.2
M2	6.0 to 9.0	7.7
M3	6.0 to 9.0	10.5
Debt	8.0 to 11.0	13.4

Regarding velocity, Mr. Volcker told the committee that:

> Unlike the pattern during much of 1982 and 1983, when M1 grew more rapidly than nominal GNP (that is velocity slowed), the income velocity of M1 rose 4 percent last year. That is broadly in line with cyclical experience in the past, taking into account both the pattern of interest rate movements and income growth. M2 velocity also increased, rising around 1½ percent following 2 yearly declines.
>
> These developments provide some support for the view that velocity trends over time, as well as cyclical changes for these aggregates, may be returning to patterns more along the lines of earlier experience.

In his testimony, Chairman Volcker identified several alterations in monetary policy during 1984 and early 1985. Specifically the Fed Chairman said that the FOMC "began to exert some additional restraint on reserves" in the early spring of 1984, that the policymaking arm decided "reserves could be provided more liberally" in the fall, and that "as monetary and credit growth continued at a rapid pace into January, the easing process came to an end."

Chairman Garn questioned Mr. Volcker on why these policy modifications could not have been publicly announced in order to reduce uncertainty in financial markets. The Fed Chairman responded that the adjustments to policy were signaled through changes in the discount rate. Mr. Volcker argued, moreover, that public announcements of limited policy modifications might lead to overreaction by the marketplace and/or might reduce the flexibility of the Fed to reverse tentative new policies.

In any case, according to the Fed Chairman, the financial markets quickly perceive a change in policy. Senator Garn responded that, if market professionals quickly identify policy changes, the general public should have access to the same information.

DOMESTIC ECONOMIC DEVELOPMENTS

Contrary to the expectations of some economists, inflation has not accelerated since the Banking Committee's last monetary policy report. During the fourth quarter of 1984, consumer prices rose at an annual rate of 3.1 percent. For the year as a whole, consumer prices rose 4.0 percent.

Growth in the output of goods and services paused in the third quarter of 1984 when real GNP grew at an annual rate of only 1.6 percent, but growth rebounded in the fourth quarter to a 4.9 percent annual rate. For the year as a whole, output was 6.9 percent higher than in 1983, and fourth-quarter real GNP was 5.9 percent higher in 1984 than in 1983.

Chairman Volcker told the committee that over the past 2 years, "we have enjoyed the strongest expansion since the Korean war period."

Chairman Volcker also told the committee that economic growth should remain healthy in 1985 and that an acceleration in the inflation rate is not anticipated. Specifically, the Chairman said that the FOMC expected real GNP growth of 3.5 to 4.0 percent this year and inflation, as measured by the GNP deflator, also to run at a rate of 3.5 to 4.0 percent.

INTERNATIONAL ECONOMIC DEVELOPMENTS

For all of 1984, the United States ran a trade deficit of $123 billion, and the deficit is expected to be even larger in 1985. One cause of this trade deficit has been the soaring value of the dollar on foreign exchange markets: The strong dollar has enabled foreign competitors to underprice American producers in both domestic and foreign markets.

The result has been growing unemployment in those U.S. industries that are most exposed to foreign competition, widespread unemployment in those regions of the United States particularly dependent on the distressed industries and a tendency for new capital investment in those industries to be made abroad rather than here in the United States. Moreover, fears have been expressed that a sharp reversal of the dollar's rise in value would drive up the price of imports and could reignite domestic U.S. inflation.

The high value of the dollar, however, has not been the only factor behind the U.S. trade deficit. Also important has been the strength of the U.S. economic expansion relative to the economic growth rates being achieved by our trading partners. Rapid growth in the United States has increased the demand for imports here at home, but slower economic growth abroad has not led to a commensurate growth in the demand for our exports.

A third factor contributing to the trade deficit has been the necessity for some of the U.S.'s trading partners to curtail their imports in order to be able to use their foreign exchange earnings to service their large external debts. Many of those same countries also have adopted tight fiscal and monetary policies that have slowed economic growth and reduced the demand for imports.

U.S. deficits on the trade and current account have been mirrored by surpluses on the capital accounts that reflect net capital flows into this country. To a large extent this net capital inflow has resulted from a reduction of gross capital outflows as U.S. banks and investors have reduced their foreign lending and investing.

To some extent the net capital inflow to the United States also has been the result of a rightward shift in the demand for savings in the United States as the country has sought to simultaneously finance a high level of investment expenditures and a large Federal Government deficit.

However, if the inflow of capital were principally due to a rightward shift in the demand for capital, the inflow would be associated with a rise in the level of U.S. interest rates relative to those abroad.

Since the last monetary policy report, interest rates in the United States have trended downward while rates abroad have moved upward. The absolute and relative decline in the level of U.S. interest rates has been accompanied by continued strong capital inflows into the United States and continued increases in the value of the dollar on foreign exchange markets.

These developments point to the conclusion that the capital inflow has resulted primarily from a rightward shift in the supply of savings to the U.S. economy as opposed to a rightward shift in the demand for savings.

The dominant effect appears to be resulting from a desire on the part of owners of capital to invest their savings in the United States to take advantage of a robust economic expansion and a high rate of return to capital resulting from the new economic policies adopted since 1981.

CONCLUSIONS

Pursuant to the requirement in the Full Employment and Balanced Growth Act for a report to the Senate by the Committee on Banking, Housing, and Urban Affairs stating its views and recommendations regarding the Federal Reserve's monetary policy report; the committee finds:

(1) Given the lack of evidence of accelerating inflation and also given the resumption of more normal growth rates for the various measures of monetary velocity, the Federal Reserve's target ranges for monetary growth in 1985 appear compatible with healthy growth in real output.

The committee has previously urged the Federal Reserve to narrow its target ranges so that financial markets will have a more precise understanding of the Fed's policy objectives. The widening of the M2 and M3 target ranges for 1985 is, in this respect, unfortunate.

The committee also is concerned over the impact on domestic monetary policy of changes in international trade flows and international capital flows. Chairman Volcker's statement noted that last year's rapid growth of debt rela-

tive to GNP may have resulted from the need to finance a surge of imports.

The committee, in addition, questions whether capital inflows into the United States could affect the domestic demand for money to an extent that monetary policy accommodation would be needed.

The committee hopes that future monetary policy reports to Congress will discuss these interactions more fully.

(2) If, as Chairman Volcker told the committee, financial markets quickly perceive modifications in monetary policy such as those made in the early spring of 1984, in the fall of 1984, and in early 1985, the Federal Reserve should again consider making a public announcement of policy modifications when they occur.

Such public announcements would reduce uncertainty over Federal Reserve policy, and this should contribute to the stability of financial markets. Public announcements of adjustments to monetary policy also would help prevent the general public from being disadvantaged vis-a-vis financial market professionals in responding to policy alterations.

(3) The size of the trade deficit and the extent of the rise in the value of the dollar clearly are cause for serious concern.

Solutions to these problems will not be easy, and some possible remedies would be unwise. Thus Chairman Volcker told the committee that a sufficiently bad monetary policy could drive down the value of the dollar.

Equally unwise would be a reversal of those economic policies that have raised the rate of return to capital in the United States. While a side effect has been to attract a capital inflow into this country that has contributed to the dollar's rise, a reversal of those pro-growth policies would undermine the economic expansion.

New trade barriers would be a third unwise policy. If the United States were to erect new barriers, our trading partners could be expected to follow suit. Resort to trade barriers also would reduce the aggregate welfare of consumers in the United States as well as those abroad.

Reduction in prospective fiscal deficits in the United States through reductions in Federal spending are essential to the long-term health of the Nation's economy. Steps to reduce these deficits, however, may not help the trade deficit or lower the dollar's value in the short run.

Lower prospective fiscal deficits may have the immediate effect of actually strengthening the dollar as they will improve the overall prospects for the U.S. economy. Over the longer term, though, lower fiscal deficits may reduce upward pressure on the dollar's value by leading to lower levels of interest rates.

The best solution to the trade deficit would clearly be through increased U.S. exports as opposed to import re-

strictions or slower economic growth here in the United States.

The United States has helped its trading partners spur economic expansions of their own by providing a robust market for their exports. As those expansions continue, the markets for U.S. exports should expand.

By providing a robust market for their exports, the United States also has helped its trading partners with large external debts to earn the dollars needed to service those debts. Progress in solving the foreign debt problems of some of the U.S.'s major trading partners will enable those countries to relax the import restrictions imposed after the 1982 debt crises. This too will help U.S. exports.

The major thrust of U.S. policy to combat the trade deficit and ease pressure on the dollar should be to focus on removing tariff and nontariff barriers to U.S. exports of goods and services. The alternatives—U.S. import barriers, slower growth and reduced efficiency—would be far worse choices for both U.S. consumers and our trading partners consumers.

MINORITY VIEWS OF SENATORS PROXMIRE, RIEGLE, SARBANES, AND SASSER

We agree with the report's main conclusion that the Federal Reserve's target ranges for monetary growth in 1985 appear compatible with healthy growth in real output. We do not, however, share the majority's concern that lower Federal budget deficits might have the immediate effect of sending the dollar even higher on foreign exchange markets.

The principal reason for our overvalued dollar is due to our enormous budget deficit. Even if Congress were to approve every single recommendation in President Reagan's budget, the deficit would still remain in the $160 to $170 billion range by the end of this decade. The failure of the President to take serious responsibility for moving toward a balanced budget has convinced the business and financial community that we do not have our fiscal house in order. As a result, interest rates remain painfully high by historical standards.

The continued heavy borrowing by the Federal Government and the resulting upward pressure on interest rates has attracted an enormous inflow of foreign capital in search of higher yields. The majority report suggests that foreign investors are more attracted by the higher growth opportunities in the United States compared to their own economies, but this line of reasoning misses the point. Foreign economies are lagging relative to the U.S. economy precisely because we have siphoned away much of their investment capital in order to finance our colossal budget deficit.

True, U.S. interest rates have declined recently while the dollar has continued to soar. But even with the decline, U.S. interest rates are still far higher than rates prevailing in most of our major trading partners. This is especially true on longer term securities as indicated on the following table.

INTEREST RATES BY COUNTRY, DECEMBER 1984

[In percent]

	Money market rates	Government bond yields
United States	8.38	12.48
Japan	6.41	6.30
Germany	5.83	7.00
France	(1)	11.35
United Kingdom	9.35	10.32

[1] Not available.

It has also been suggested that much of the reason for the net inflow of foreign capital has been due to the reduced lending abroad by American banks and other investors. While foreign lend-

ing by U.S. banks has certainly declined, foreign investment in U.S. securities has remained consistently high by historical standards. During the last 4 years, foreign investments in the United States increased by an average of $85 billion a year, an increase of 60 percent over the average for the preceding 4 years. The sharp increase in foreign investment over the last 4 years went hand in hand with the rapid increase in the Federal budget deficit.

We will not be successful in bringing the dollar into a proper alignment with foreign currencies nor in reducing our burdensome trade deficit unless and until we begin to show satisfactory progress in closing our budget deficit. It is not enough to point the finger of blame at foreign governments and suggest they should do more to spur their lagging rate of economic growth. When we drain funds from the international financial system to finance our own deficits, we become a major obstacle to world wide economic recovery.

WILLIAM PROXMIRE.
DON RIEGLE.
PAUL SARBANES.
JIM SASSER.

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